INTRODUCTION

A NEW LEASE OF LIFE FOR NEXT GENERATION FUNDS

Widespread falls across the board during the financial crisis meant that the diversification benefits associated with multi-asset funds did not materialise. Investors' faith in these products was understandably shaken, but, asks Elisa Trovato, is interest starting to pick up?

The extraordinary rise in correlation between asset classes last year, when all investments fell at the same time, hit multi-asset funds particularly hard.

Indeed, the raison d'être of these strategies, which represent an evolution of the more traditional balanced funds investing in equities and bonds, is to offer diversification by spreading money across different asset classes and geographies, and aim at reducing the overall risk of a portfolio for a given level of expected return.

Nevertheless, new successful launches in this space indicate that appetite for these more complex instruments is coming back.

ATTRACTING INFLOWS

The HSBC World Selection range, a globally-diverse multi-manager, multi-asset fund available to UK distributors has attracted £500m (€555m) within the first six months of launch. "We launched our range in January at a time when you might have thought that launching a multi-asset range was not the right thing to do," says Joanna Munro, CEO, Multi-manager at HSBC Global Asset Management.

But one of the big lessons that people have learned from the financial crisis is the importance of relying on experts to make investments and asset allocation decisions, without the investors having to worry beyond making initial investments in this product, says Ms Munro. "That's clearly touched a need in the market," she says.

Since inception in January, the core multi-asset fund of the HSBC World Selection range delivered, gross of fees, approximately the same return as the MSCI World benchmark, 10 per cent, with around one third of the volatility, 8 per cent versus 22 per cent of the benchmark, claims Ms Munro. HSBC runs similar products for cross border and global distribution.

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The HSBC world selection range offers three risk

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profiles for retail investors but it can also be customised to meet high net worth investors' specific needs.

"A multi-asset fund is not a simple product; it needs a lot of resources and a lot of expertise to make it work properly," warns Ms Munro.

In addition to the return offered by the individual asset classes and active allocation decisions, further value to the portfolio is provided by picking the best managers. "We interpret multi-asset funds as multi-manager funds as we don't believe that anyone manager can be the best at everything."

It is debatable whether these products are more suitable in a volatile or stable market. "If you buy this product in a volatile market, you might be entering them at the wrong time," says Ms Munro. "I genuinely think that multi-asset funds are all weather products, this is how we design them."

THE FAILURE OF DIVERSIFICATION

What the crisis has brought to the forefront of investors' minds is that diversification did not work and "buy and hold" approach proved wrong, acknowledges Dr Peter J. Mathis, head of fixed income core and private banking discretionary platforms at ING Investment Management.

Most managers use a fixed allocation between different asset classes with no or very little active management, and this is why a lot of people are disappointed with these products. "When correlation started to move to one and all assets went down, a lot of products got hurt last year. What is really important is to actively manage the downside risk of the investment, in order to limit the maximum loss that a client can have at any point in time."

Some of ING's multi-asset funds have an active management of a predefined maximum Value-at-Risk (VaR). This ensures that over a 12 month horizon investors can limit their losses to a certain fixed percentage, say, 5 or 10 per cent of their money, with a 95 per cent level of confidence.

"A very active asset allocation is needed to achieve the highest possible total return given the level of risk, and if you employ external managers to run part of your money, in a fund of funds structure, you need to adopt a hire and fire approach with them," says Dr Mathis.

There are about 40 asset classes that can be employed in the fund and a vast amount of instruments, such as funds, ETFs or direct lines, he explains. "We also use derivatives for hedging purposes, predominantly futures and currency forward," says Dr Mathis.

Monitoring 40 different asset classes does not mean that there are always so many in the portfolio, explains Dr Mathis. "We are looking at what are the most attractive ones, we are very opportunistic. We generally employ 20 to 25 asset classes in our multi-asset funds."

Bruno Saugnac, head of global balanced fund management at Crédit Agricole Asset Management, also strongly advocates the importance of using more flexibility in products.

"Clients are more demanding, are expecting more from managers in terms of their ability to be reactive. At CAAM we are moving towards more flexible type of products," he explains. Recent products launched at CAAM can move their exposure to the equity market from 0 to 50 or 60 per cent. "Market volatility is certainly one of the factors driving investors' interest in this kind of product," adds Mr Saugnac.

"In current market conditions it is paramount to be able to use this flexibility in terms of asset allocation, and be able to focus on the segments that the manager thinks offer the best value. This allows to reduce risk and to take advantage of the opportunities that a very volatile market presents," he says. "A flexible fund enables the fund manager to be opportunistic."

Another important feature is protection. In addition to being very flexible in terms of asset allocation, the new multi-asset products at CAAM incorporate a maximum loss target that can be formally guaranteed.

"We differentiate between VaR and maximum loss

product," explains Mr Saugnac. "We have been using VaR as a measure of risk for many years, but our maximum loss products are a bit different."

While VaR gives a probability of 95 per cent of not losing more than a certain percentage, with a 5 per cent probability of losing more in the event of adverse market conditions, the maximum loss approach targets a maximum loss under any market conditions.

"The management of maximum loss products combines the VaR approach with portfolio insurance," he explains.

"Our commercial efforts really focus on products combining elements of both flexibility and protection." The French firm managers around 80 multi-asset or asset allocation funds but it is mainly promoting a handful of flexible funds through its retail and private banking networks.

A WIDE INVESTMENT UNIVERSE

Unlike asset allocation products, which also represent an evolution of the classical balanced funds, where a key source of returns is provided by active allocation between equities and bonds, multi-asset products tend to use a very wide investment universe, including non conventional asset classes such as volatility and forex, says Mr Saugnac.

Unlike some of its competitors, CAAM multi-asset funds do not invest in alternatives. "Our position is to focus on very liquid asset classes to maintain a high level of liquidity of the portfolio; we will always use Ucits III products with daily liquidity."

One of the benefits of multi-asset funds is that moving money from an asset to another is cheaper, compared to having different funds investing in individual asset classes, says Mr Saugnac.

"Instead of having a portfolio made of different asset classes, there is just one fund which buys and sells, moving positions is much cheaper for the investor, as the cost is covered by the management fee."

A more slow-moving investment approach is followed by the Newton Phoenix multi-asset fund, managed by Phil Collins, at Newton Investment Management.

"Our key skills are more analysis than trading, and although we still have a reasonable level of dealing, our job is to remain diversified whatever the market conditions. We will shift the asset allocation towards the assets that we think will perform best, but we won't do wholesale, so there will be 10 to 20 per cent movements," says Mr Collins.

Nevertheless, the financial crisis has driven the UK company to review its constraints in terms of how much the fund could invest in any one asset class.

"We have added a bit more of flexibility to move between the different assets, this was reflection of what happened last year when correlation was high and all assets fell," he says.

"We just wanted to increase our flexibility a bit more to come out of risky assets, if they were falling at the same time or if we forecast that was about to happen," says Mr Collins, who has been managing the fund since inception in 2003.

Mr Collins realistically says that multi-asset funds are probably less popular with investors, especially after a poor year in 2008. "There is now a drive for greater simplicity and in the range of multi-asset funds that you could buy we are probably at the simpler end. We are not involved in complex derivatives strategies or some of the esoteric areas."

"I think it will take a few years for these funds to rebuild the trust that people have in them," he says, yet pointing that even if multi-asset funds did not perform well last year, they still performed better than equities.

Newton also offers a more aggressive version of this multi-asset instrument, the Newton real return fund, which adopts a more flexible approach.

The way these multi-asset funds are employed in

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clients' portfolios varies depending on clients' personal circumstances and risk profile, explains Gavin Rankin, head of investment advisory at UBS Wealth Management in London. "We do recommend these products for a number of our clients, for example for a portion of our resident non domiciled client base." Tax is the main driver in this case.

"In order to shield their portfolio from tax on an arising basis, they would want the benefit of holding their asset allocation in a wrapper," he explains. In a multi-asset class fund anytime the manager reallocates between the asset classes, there is no tax charge to the investor. For UK resident non domiciled clients, the benefit is greater because of the new tax regime.

For investors that are looking for asset allocation solutions as a level of incremental risk, ie taking some manager risk, where they believe the manager has good credibility and good track record in determining returns, the multi-asset class solution can be recommended as a part of a diversified portfolio, says Mr Rankin.

"Typically, a multi-asset fund would not be recommended as the core asset allocation solution, but it will be either part of the core or a satellite part of the overall portfolio," he says.

"If clients wanted to invest their portfolio in multi-asset funds, we would typically recommend that they use a number within their portfolios to diversify the manager risk, which is going to be greater, the more active decisions the manager makes within the portfolio," says Mr Rankin.

HIGHER LEVELS OF RISK

The manager risk for absolute return type of products, targeting cash plus returns, which have a more aggressive asset allocation is even higher in volatile times. "In volatile times you are running a higher level of risk, so the likelihood is that you are heavily exposed to manager risk, the manager's view of the world. Experience over the past couple of years is that many of those managers were too optimistic when they should have been more pessimistic," explains Mr Rankin.

"From the prospective of our client base the biggest issue with multi-asset class funds has been those managers that have taken high levels of tactical asset allocation or risk or have been managing absolute return mandates," he adds.

Usually these so-called multi-asset funds only invest in equities and fixed income, as they are limited in investing in other asset classes according to Sicav listing rules. Therefore they can never constitute a complete solution for the clients. Those multi-asset funds that claim to invest in alternatives typically invest in listed instruments, and are not getting the full return profile of the asset class, but they are getting a high level of equity exposure, explains Mr Rankin.

"The multi-asset class solutions I refer to are much purer multi-asset class solutions, including effectively equities and bonds."

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However, Ucits rules are opening up more flexibility for some of the instruments that can be used within these portfolios, he says. "The other trend is that hedge funds are creating onshore vehicles under the Ucits regime, and as that develops, that will give some level of flexibility to multi-asset class funds," predicts Mr Rankin.

On the other hand, Ms Munro at HSBC explains that in order to have daily liquidity in every class that makes up the product, you need to use listed property and listed private equity. They may have more price volatility, but they also add diversification, she says. Depending on the jurisdiction of the structure, it is possible to have a percentage of 10 per cent in non Ucits alternative asset classes.

"We think that this breadth of asset class diversification is a real benefit, and we use the full flexibility that the regulation allows," says Ms Munro. Over the past 2-3 years, the range of multi-asset funds at HSBC has evolved to include increasingly more alternatives, first in 2006, via the launch of the Open Funds Range under the UK non-Ucits retail scheme (Nurs), which allowed the use of alternatives, and then the HSBC World Selection range, which has an even broader diversification and it is designed "as a core product for investors," she says.